

PROGRAM BUDGETING: A NEW BUDGETING PROCESS FOR UKRAINE¹

With the 2002 budget Ukraine has embarked down the path of introducing program budgeting into its budgetary process. Because program budgeting represents a new way of formulating budgets and because few are familiar with this budgetary technique, this note explains the rationale and origins of program budgeting as well as the future steps that are required to successfully implement it in Ukraine.

The first part of this note sets out the general principles of program budgeting and the basis budgetary philosophy that underlies it. The second part discusses the expected benefits from adopting program budgeting. In the third part the history of program budgeting and its use in other countries is briefly described. The final part of this note outlines the next steps Ukraine will need to take to fully implement the practice of program budgeting.

I. What is Program Budgeting? What is a Program?

A program is a set of related budgetary activities that are required, or thought to be required, to realize a common budgetary result or outcome. Each program is identified with a unique budgetary goal. All activities included in a program should be capable of being represented in one major functional classification of the budget.

Program budgeting is the practice of grouping different kinds of budgetary expenditures into separate programs so that every expenditure is assigned to some kind of program. Typically, each program is the fiscal responsibility of a single key spending unit whose performance is assessed in light of its success in achieving its program goals.

To adopt program budgeting is to embrace a significant shift in budgetary mindset. It is useful to think of the budgetary process in terms of a production function linking budgetary outcomes to the public sector resources used to produce these outcomes. In this context, one approach to designing a budget is to think primarily about the inputs that are used to produce public sector outputs. Traditional practices of formulating budgets often focus on the inputs of the public sector production function and frequently pay scant attention to the nature of the outputs that are produced. Program budgeting, on the other hand, adopts an entirely different focus in budgeting and begins the budget formulation process by riveting attention initially on the outputs that are to be produced by the public sector and then asking what are the most appropriate resources to use to achieve these outputs. Outputs in this framework represent what the government intends to accomplish, or the priorities that are to be pursued, through public sector actions.

With the introduction of program budgeting the nature of public policy debate on budgetary issues changes markedly. Compliance concerns begin to be considered as less important than performance concerns. Policy makers begin to focus on what value society receives for money spent. Instead of inquiring whether public funds have been properly spent in fulfilling the budget plan, questions are more likely to be raised about how well the funds have been spent in achieving the goals of public policy.

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A small example may serve to clarify the notion of program budgeting. The Ministry of Health is a key spending unit in most countries and normally operates an array of different health programs. Maintaining and improving the health of its citizenry is the overarching mandate of this Ministry. To accomplish this end, the Ministry manages and finances a variety of health care programs. These may include immunization, public awareness, medical training and hospital expansion programs among others. To measure its performance the Ministry will ordinarily collect and report on health level statistics such as life expectancy and morbidity of different diseases that indicate how effectively its programs are being carried out. In addition, separate programs will establish their own performance indicators. In the case of immunization, for example, the goal might be to vaccinate 80 per cent of the population with a new vaccine over the next two years. By setting such targets, budget requests can be formulated on the basis of the resources that would be required to meet these targets and program managers can be held accountable for seeing that these targets are met.

As the previous example suggests, the elaboration of performance indicators is an important component of program budgeting and these indicators take a variety of different forms. Normally three types of indicator are developed for each program. Input indicators measure the budgetary resources that are allocated to a program and the performance criterion in this case is the traditional concern of compliance with the budget plan. Output indicators measure the goods and services provided by a program. In the health care example the number of vaccinations administered would be one measure of program output. Finally, outcome indicators gauge the broad results of the program in light of their impact on people's welfare. A decline in the incidence of a particular disease would be one example in the case of the vaccination program mentioned.

Developing reliable performance indicators is usually the responsibility of the key spending unit that manages a program. The role of the Ministry of Finance is to approve the choices for the indicators made by the spending unit to ensure they are consistent with the Ministry's policy initiatives, although there may be cases where the Ministry could assist in making those choices. As part of this process, the spending unit should also develop targets for each performance indicator to justify its expenditure requests. Since each spending unit is subject to a spending ceiling, the unit will need to create procedures for internal consultation that will allow it to reconcile its ability to meet its chosen targets with the amount of budgeted resources.

The key spending unit is also responsible for defining and implementing the procedures that are to be used for performance appraisal under the oversight role exercised by the Ministry of Finance. This task will require the spending unit to generate the output data needed to carry out the appraisal. Some of these data may be captured through the routine reporting of achievements by service delivery agencies controlled by the key spending unit. Reporting of this nature may be critical in distinguishing between good and bad service performers. Other kinds of relevant data, however, may require household surveys conducted by the State Statistical Service. No matter whether the data originate from internal or external sources, each of them is vital to the creation of a new systematic evaluation culture.

II. What are the Benefits of Program Budgeting?

By concentrating on the results and accomplishments of government activity, program budgeting promises to enhance the efficiency and effectiveness of the public sector. From an analytical perspective, program budgeting inserts important elements of benefit-cost analysis into the budgetary process. Benefit-cost analysis is a technique for evaluating projects and insuring that only projects whose measured benefits exceed their costs are accepted and

undertaken within the public sector. If this technique were systematically applied to all government activity it would significantly enhance the efficiency of the public sector. However, because many of the outputs of the public sector are of an intangible nature, for example, national security, many parts of the public sector do not lend themselves to an easy application of benefit-cost analysis. In cases such as this where benefits are difficult to measure, a weaker efficiency criterion, cost effectiveness, is frequently employed instead. Cost effectiveness analysis requires public sector policy makers to search for the least cost method of attaining a particular level of public sector output.

The practice of contracting out is an important example of how the cost effectiveness criterion is applied in many countries. While the government may be responsible for providing public services, this responsibility does not imply that the government should necessarily produce these services itself. In many cases, for example, trash collection, it may be cheaper, and therefore more cost effective, to contract with private sector suppliers to provide these services. Program budgeting ordinarily requires key spending units to conduct cost effectiveness analysis for all of their activities and thereby contributes to a more efficient public sector.

In addition to these kinds of direct efficiency benefits, program budgeting brings indirect efficiency gains to the public sector by making public sector managers accountable for their accomplishments. Under program budgeting there are strong incentives for public sector managers to adopt more effective management methods because their rewards, and prospects for promotion, are more closely tied to their ability to achieve the explicit goals set out by program budgeting.

Because of the reporting and evaluation framework it creates, program budgeting imparts a much higher level of transparency to public sector decision making. With program budgeting both the public and the legislative branch of government can obtain a much clearer picture of what key spending units are doing and how, and how well, they are accomplishing their tasks. This clearer picture in turn fosters a policy making environment in which it becomes possible to make more rational public finance decisions concerning the level and composition of government spending.

Program budgeting also inherently strengthens the budget process itself. Once the goals of program budgeting are established, key spending units are forced to submit more disciplined requests for funds explaining in greater detail the justifications that lie behind these requests. This enables the Ministry of Finance to determine with greater accuracy whether budget requests are consistent with the aims of a particular program.

III. Who Uses Program Budgeting?

Program budgeting originated in the United States during the middle 1960's. It was initially applied in the department of defense by Robert McNamara, the department secretary, who imported the concept from the Ford Motor Company which he used to head. The president of the U.S. at the time, Lyndon Johnson, liked the approach so much that he ordered all other departments of the federal government to adopt it.

Since then the practice of program budgeting has spread to a number of other countries and, as well, to subcentral tiers of government in many of these countries. Canada and most members of the European Union, for example, are diligent practitioners of the art and science of program budgeting. Now most European Union support to other countries is in the form of

program support. And in the United States program budgeting is now used by most State and municipal governments.

There is a growing consensus that the most advanced practitioners of program budgeting are Australia and New Zealand. A glance at the regular budget reports issued by these two countries reveals a remarkable level of clarity and transparency about what their government departments are doing and, as a result, they are often held up to be models for the rest of the world to emulate.

IV. What Further Steps are Needed in Ukraine to Implement Program Budgeting?

There is in the 2002 draft budget a complete listing of all expenditure activities carried out by the different key spending units of the State budget. For the first time, it is possible to discern in considerable detail how the State uses the funds at its disposal. There is, however, no visible program structure and the next step is to group similar activities into a sensible program budget format.

Once a program structure is in place, each program, with few exceptions, should be assigned to a single key spending unit and linked to the existing functional classification of expenditures. After that each key spending unit needs to develop and announce a clear mission statement outlining the broad objectives of the unit. Subsequently, each of these units will need to define short-run or interim objectives, which if they are achieved, will permit the unit to accomplish its broad, longer term, objectives. The final, and in some ways most demanding, step is to create reliable performance indicators for each program that can be used to measure progress towards the attainment of both short and long term objectives. This final step is an extremely data intensive exercise and may only be realized over an extended period of time because the necessary data are not always readily available. Success in this area may also require the active participation of the sectoral departments within the Ministry of Finance.

The process outlined above is likely to take two or three years before it is completed. During this time a critical need will emerge to train government officials in how to properly apply program budgeting procedures and to produce new budget request and other forms that serve the purposes of program budgeting.